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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking into the Review of the California High Cost Fund B Program	R.06-06-028 (Filed June 29, 2006)

OPENING COMMENTS OF
THE DIVISION OF RATEPAYER ADVOCATES
ON PHASE II ISSUES

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Pursuant to Rule 6.2 of the Commission's Rules of Practice and Procedure, and the Ruling by Administrative Law Judge Pulsifer granting modifications to the filing dates for comments on Phase II issues in Rulemaking (R.) 06-06-028,[1] the Division of Ratepayer Advocates (DRA) submits these Opening Comments in response to the issues identified in the October 5, 2007 Assigned Commissioner's Ruling Regarding the Scoping and Scheduling of Phase II Issues (10/5/07 ACR).

I. EXECUTIVE SUMMARY

These comments present DRA's preliminary views on reverse auction issues (Section 2.1 of the 10/5/07 ACR), as well as its views on cost proxy model update issues (Section 2.2 of the 10/5/07 ACR) and on other Phase II issues (Section 3 of the 10/5/07 ACR). Key positions include:

- DRA strongly recommends that the Commission focus on reverse auction and affordability issues first, deferring any effort to update cost proxy model results until after the Commission has determined whether any such update is necessary in conjunction with the preferred auction methodology.

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[1] Electronic mail from Peter Casciato, Time Warner Telecom of California, L.P., to the Service List for R.06-06-028, dated October 19 2007, with subject line "Fwd: RE: October 5, 2007 Assigned Commissioner's Scoping and Scheduling Ruling: Request to Unify Filing Dates And Extend the Filing Schedule 4 days."

- The Commission should not simultaneously pursue cost modeling and designing a reverse auction process. The Commission should not engage in cost modeling at all for the purpose of determining what areas of the state are truly "high cost," and thus merit subsidies, unless it cannot design a viable reverse auction mechanism.

- If the Commission does pursue an update of results from the HAI Model Version 5.3 (HM 5.3), it should cap the results that the model produces (preferably by referencing the alternative price of intermodal options such as wireless services) and should limit support for existing lines to the operations and maintenance (O&M) costs derived from HM 5.3.

- DRA supports trying to pursue competitive neutrality in the California High Cost Fund B (CHCF-B or B Fund) program by investigating whether intermodal carriers are interested in participating in the program, and the ability of those companies to provide the services that should be supported by the B Fund. The Commission should reconsider, from a contemporary perspective, the services that should be considered "basic" for residential consumers. As part of that review, the Commission should invite potential B Fund recipients to identify the current basic service elements that they cannot provide, and whether they can provide alternative services that may meet the Commission's goals of ensuring a basic level of telecommunications service that is both ubiquitous and affordable.

- The Commission should also conduct workshops to obtain the input of potential bidders about reverse auction design and other related issues.[2] While written comments are helpful in putting some ideas forward and crafting the agenda for workshops, DRA believes that the face-to-face discussions that workshops are the most effective and efficient means to tackle these complex issues.

- The Commission should conduct a reverse auction pilot program involving at least two different geographic areas to develop a real-world understanding of how the auction process functions in the context of the B Fund. This will allow the Commission to objectively measure the success of the pilot projects and identify any problems of such a groundbreaking program prior to statewide implementation.

- If an auction is held and no bids are received, the Commission should require the incumbent local exchange carriers (ILECs) to continue to serve as carriers of last resort (COLRs).

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[2] The Commission should also solicit information about potential bidders that may not be aware of the Commission's reform of the B Fund.

- If an auction is held and no bids are received, and the ILEC still requests the subsidy, that ILEC must make a cost showing to the Commission demonstrating that the subsidy continues to be necessary.
- If an ILEC is not the winning bidder, it must still be required to make its facilities available for resale.
- There should only be one subsidized COLR in a given geographic area in order to avoid unnecessarily increasing the size of the B Fund.
- The Commission should establish minimum service quality standards to which reverse auction bidders must adhere.
- The reverse auction bids should be to provide agreed upon services, at agreed upon prices, with determined service quality standards for a fixed period of time.
- The Commission should impose a cap on the amount of subsidy payments per line.
- During the transition to full pricing flexibility, the Commission should explicitly impose an interim rate cap upon the URF ILECs residential basic service equal to SureWest's $18.90 basic service rate. This amount should also be used for the permanent COLR rate cap, which more generally sets the limit on how much a COLR can charge for basic residential service in a subsidized area.
- The Commission should limit increases in the basic service rate to a maximum of $2.00 per year up to the level of the rate cap in order to mitigate rate shock.
- The Commission should require that all ILEC service providers' maximum rate be no higher than 150% of their lowest rate. This relative rate cap should also be applied to non-ILEC COLRs in a modified form.[3]
- The Commission should have Field Research conduct a modified version of the Affordability Study.
- The Commission should periodically review the B Fund program.

[3] For example, the Commission could identify a certain amount as a proxy for the "lowest rate" when applying the relative rate cap to a non-ILEC COLR. The "lowest rate" proxy could be based on the actual lowest rate that the closest ILEC has (or had) at a certain point in time.

II. THE COMMISSION SHOULD FOCUS ITS ATTENTION – AND THAT OF INTERESTED PARTIES – ON ISSUES RELATING TO THE REVERSE AUCTION AND AFFORDABILITY

The 10/5/07 ACR recognizes the challenge of addressing the broad array of issues it raises and asks parties to comment "on the appropriate manner in which to sequence and prioritize respective tasks involved in implementing a reverse auction and updating relevant high-cost proxies, recognizing the inherent limitations in the HM 5.3 modeling approach."[4] DRA encourages the Commission to focus its attention – and that of interested parties – on issues relating to the reverse auction and also to give priority to the outstanding affordability issues identified in Section 3.1 of the 10/5/07 ACR.

In D.07-09-020, the Commission set a viable path for interim reductions in CHCF-B funding without necessitating any update of cost proxy model results. The urgent need now is to determine, as quickly as possible, the feasibility of relying on a reverse auction mechanism to set long-term universal service support levels. Updated cost proxy model results will play, at most, a limited role in the auction process; therefore, the Commission should keep this proceeding on track by deferring the relatively unimportant cost modeling exercise. Few, if any, parties have the resources to pursue cost modeling on a partially parallel track to the auction design. Allowing parties to concentrate their efforts on auction design and implementation issues is the best way to achieve the Commission's groundbreaking goal of relying on a market-based auction, rather than litigation of cost studies, to determine efficient universal service support levels.

III. DRA'S PRELIMINARY VIEWS ON REVERSE AUCTION DESIGN AND IMPLEMENTATION (SECTION 2.1)

Section 2.1 of the 10/5/07 ACR poses a series of questions concerning the design and implementation of a reverse auction for universal service support. Below, DRA provides its preliminary views on those questions. DRA emphasizes, however, that the views presented here are truly preliminary and are subject to revision upon further

[4] 10/5/07 ACR at 2.

research, review of other parties' comments, and information obtained through the contemplated workshop process.

The success of any reverse auction will depend on having a sufficient number of qualified bidders participate. Therefore, as Paul Milgrom, Stanford economist and a leading architect of the FCC's spectrum allocation auctions, emphasizes, there is great value in having the potential bidders involved in designing the auction, so that the auction is structured in a way that encourages them to bid.[5] DRA suggests that the Commission use these initial rounds of comments to assess whether there is sufficient input from potential non-ILEC bidders and, if not, to take steps to broaden their participation prior to the workshops. In addition to various wireless bidders, DRA recommends that the Commission instruct its staff to seek out service providers offering satellite, broadband over powerlines, fixed VOIP and municipal broadband systems as workshop participants or to bring information to the workshops regarding why such potential competitors are not interested in the bidding process. Active input from potential bidders (ILEC and non-ILEC alike) will influence DRA's further views on the issues raised in Section 2.1 of the 10/5/07 ACR, and will be an invaluable guide to the Commission in deciding how best to move forward. Silence on any particular issue should not be construed as assent.

With this preface in mind, DRA now responds to the specific questions in the 10/5/07 ACR.

1. *Are there any statutory limitations to designating COLRs through an auction process?*

DRA supports Commission adoption of technologically neutral policies to encourage broad participation in the voice market in California. This is particularly important in a reverse auction context because, as discussed below, one of the most crucial components of a successful auction is the availability of willing bidders.[6] In this

[5] Paul Milgrom, *Putting Auction Theory to Work*, New York: Cambridge University Press, 2004 (Milgrom), at 26.

[6] *See* DRA's discussion in Section III below.

respect, however, Public Utilities (PU) Code § 739.3(c), the statute authorizing the B Fund program, may impose some statutory constraints.

For example, § 739.3(c) requires that "transfer payments" from the fund be provided to "telephone corporations serving areas where the cost of providing services exceeds rates charged by providers, as determined by the commission."[7] The term "telephone corporations" is broadly defined in the PU Code as "every corporation or person owning, controlling, operating, or managing any telephone line for compensation within this state."[8] A "telephone line," in turn, includes all equipment that "facilitate[s] communication by telephone, whether such communication is had with or without the use of transmission wires."[9]

While ILECs, CLECs, and wireless providers are "telephone corporations" and potential B Fund auction participants, it is unclear whether there are other potential auction participants that are not currently considered "telephone corporations." Regardless of how an entity is currently categorized, it should be able to participate in a B Fund auction if it can provide the elements of basic service, as reconsidered in this proceeding.[10] DRA also notes, however, that in requesting a subsidy to provide affordable basic phone services in a high cost area, a potential bidder must necessarily subject itself to a certain level of Commission jurisdiction. The Commission has already determined that a COLR must annually certify that its basic service rates are below a certain level in order to continue to receive B Fund support.[11] Other requirements, like monitoring and service quality, will likely be necessary to ensure, among other things, that a winning COLR is providing the services to which it has committed.

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[7] PU Code § 739.3(c) (emphasis added).

[8] PU Code § 234(a) (emphasis added).

[9] PU Code § 233.

[10] In response to the questions in Section 3.3 of the 10/5/07 ACR, below, DRA recommends that the Commission reconsider the definition of basic service.

[11] D.07-09-020 at 133.

Currently, wireline providers subject to the Commission's jurisdiction must obtain a Certificate of Public Convenience and Necessity (CPCN) to provide intrastate phone services in California, while wireless providers providing services in California must register with the Commission. To the extent that a potential auction bidder is not a traditional phone company and/or has not obtained certification or registration with the Commission, the Commission could allow potential bidders to seek "provisional" authority to offer services in California and enable them to participate in the auction process without the need for a full certification process.[12] While a winning bidder would need to subject itself to the Commission's jurisdiction and become a "telephone corporation" consistent with PU Code § 739.3(c), failing bidders could withdraw their requests for authority to offer intrastate services without prejudice.

2. *What processes and protocols should be established to implement a reverse auction for purposes of assigning COLR obligations and setting the level of subsidy support in high-cost areas served by the existing incumbents? Is a descending bid, simultaneous-close auction the best type of auction to determine support?*

Without an opportunity to assess input from potential bidders, DRA is not prepared to offer an opinion on the *best* type of auction to determine support. A descending-bid, simultaneous-close auction has attractive properties that parallel those of the ascending-bid, simultaneous-close spectrum allocation auctions over which the FCC has presided. Nonetheless, other types of auctions might encourage more bidders and produce better outcomes in the universal service context.[13] DRA encourages the

[12] The Commission could establish certain minimum requirements that a potential bidder must meet, such as a demonstration of the financial fitness of the company to provide services in California.

[13] For example, if the bids are for territories as small as a Census Block Group (CBG), bidders might be more interested and offer higher bids if they could be sure they would be selected for multiple adjacent CBGs that add up to a coherent service area. So-called "combinatorial auctions" (which include both "package" and "contingent bid" auctions) could address this logical bidder concern and thereby encourage more qualified bidders to participate in the auction(s).

Commission to avoid locking itself into a particular auction construct and to explore an array of alternatives in the contemplated workshops.

More generally, DRA suggests that the Commission evaluate potential auction designs based on the four criteria implicit in the following statement by auction expert Paul Milgrom:

> My experience in auction consulting teaches that clever new designs are only very occasionally among the main keys to an auction's success. Much more often, the keys are to keep the costs of bidding low, encourage the right bidders to participate, ensure the integrity of the process, and take care that the winning bidder is someone who will pay or deliver as promised.[14]

These requirements imply the need for an efficient process that includes well-qualified bidders, is designed to avoid collusion, and provides strong incentives to ensure that California consumers will receive the breadth and quality of services promised by the winning bidder for a subsidy that does not exceed the bid amount.

3. *The auction mechanism will require a bidding process predicated upon appropriate parameters of acceptable COLR service. What eligibility criteria for carriers and service quality standards should be established as a basis for reverse auction bidding? For example, what minimum standard of reliable 911 service would be necessary to qualify as a COLR as a result of a reverse auction bid? Should COLR status be granted for only a limited time subject to periodic renewal? If so, what should be the duration of COLR status?*

DRA believes that answering this set of questions should be the centerpiece of the Commission's early efforts to design a reverse auction for California's universal service needs. Both economic theory and experience with other auctions support the conclusion that even the "best" designed auction is unlikely to produce a good result if there are too few bidders. Thus, in the initial stages of auction design, DRA recommends that the Commission concentrate its efforts on setting the parameters of who is eligible to bid in a way that will maximize the number of serious bidders, subject to the critical constraint

[14] Milgrom, Preface at xiv.

that those bidders will offer – and deliver – a service that is acceptable to meet universal service needs in California.

In this regard, DRA notes that the Commission may need to revisit some of its existing requirements for universal service to ensure that they do not needlessly exclude otherwise-qualified intermodal bidders. For example, concerns about emergency 911 services have loomed large in prior considerations of the kinds of service providers that make acceptable COLRs. Under the interpretation of Public Utilities (PU) Code Section 2883 embodied in the pending Presiding Officer's Decision in Case (C.) 05-11-011 (filed October 10, 2007), however, the ILECs are obligated to offer residences 911 services over their existing facilities indefinitely (subject to a much more limited interpretation of the legislative exceptions implied by AT&T's practice of turning off "warm-line" emergency services after 180 days), even for residential consumers who have never subscribed to the ILECs' basic services. Having this safety net in place may make intermodal providers (such as wireless providers) more acceptable as COLRs.

DRA believes that establishing adequate service quality standards is an important component of the bidding process. The Commission should establish these standards prior to opening any auction, so that prospective bidders will know what they must provide and thus can properly assess the cost of providing service and construct realistic bids. These standards should be structured in a fashion that allows intermodal bidders, while still meeting universal service goals, but still ensures that consumers receive high-quality, reliable, and innovative service. Moreover, assuming that some ILECs would not win the auction in a service area, the likelihood that the ILECs would continue to offer service over their existing wireline facilities (albeit perhaps at a higher price than the subsidized rate), if they did not receive the winning bid in a particular area, means that customers in high-cost areas would have the option of paying extra if they deemed the perceived additional quality of service to be worth the money.

DRA also preliminarily recommends a time-limited service obligation for the winning bidder, with periodic review, so that the Commission will have regular opportunities to test the waters for lower bidders. At the same time, DRA recognizes that the winning bidder must be assured of being the COLR for a sufficiently long period to make it profitable for that provider to build out any facilities necessary and to recoup other costs associated with the auction.

4. *Should threshold standards, such as financial fitness, be adopted to qualify to bid in the auction? Should there be a bond required?*

Consistent with the criterion identified above that a well-designed auction should "take care that the winning bidder is someone who will pay or deliver as promised,"[15] DRA recommends that the Commission establish threshold standards (similar to the financial fitness and other considerations evaluated when a provider applies for a Certificate of Public Convenience and Necessity (CPCN)) and that it strongly consider requiring a bond.[16] (It is DRA's understanding that the federal spectrum allocation auctions include a bond requirement.) Auctions may determine the only affordable source for basic communication service (other than warm-line access to 911) for portions of rural California. The Commission should ensure such vital functionality is secure.

5. *What sorts of regulatory compliance requirements should apply to a selected bidder? Should reliability standards be placed on COLRs? What Commission audit requirements may be warranted to verify and confirm that a winning bidder follows through with commitments to meet such specified minimum basic service quality standards? Should any penalties for withdrawal, such as the difference between the winning bid amount and the next carrier or reauction bid amount, be imposed?*

The questions posed here are critical consumer protection issues and thus are essential to the successful outcome of any auction. DRA perceives a need for reliability standards and for some form of Commission audit and/or verification that a winning bidder is complying with these standards, but would like to discuss these standards with other parties in workshops before committing to any specific recommendations.

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[15] Milgrom, at xiv.

[16] DRA notes that the level of financial fitness and long-term viability of a COLR is significantly more important than those of a company applying just applying for a CPCN.

Preliminarily, DRA recommends that there be penalties for withdrawal based on the difference between the winning bid and the next carrier or re-auction bid amount. DRA also preliminarily recommends penalties for failure to participate actively throughout the auction process. These penalties might include forfeiture of a bidder's bond for failure to participate at all, and limitations on the number of service areas on which a bidder can make bids in later rounds of the auction based on the number of bids that bidder makes in the earlier rounds. The goal of such requirements should be to ensure active, honest and non-collusive participation in the auction by serious, qualified bidders.

6. *What service(s) should be included within the bid covered by the reverse auction? (Parties may incorporate, by reference, comments on CASF issues, to the extent deemed relevant.) What limitations or conditions should be placed on service(s) that may be included within (or excluded from) the bidding? Are there other elements that should be part of bid than the amount of universal service support for the specific area? Should bids to be placed on total support, support per subscriber, support per household, or some other basis?*

DRA recommends that the array of services to be included in the auction be discussed with potential bidders in a workshop setting. While DRA encourages the Commission to avoid locking itself into particular service requirements and explore an array of alternatives in the contemplated workshops, DRA tentatively suggests that bids be placed on a support-per-line basis.

7. *In what geographic area(s) should the initial auctions be held? How many separate auctions will be required? What is the appropriate transition time to phase-out existing COLR support and phase-in new COLR support? Should the same timeframe be used to phase-in coverage and other COLR obligations? Should build-out benchmarks be established?*

DRA believes that it is premature to attempt to establish these auction parameters until the Commission works through other details of the auction and determines what it will take to assure a sufficient number of qualified bidders. As DRA discusses in its next response, however, a pilot project in at least two geographic areas would be desirable before the Commission commits to complete reliance on the reverse auction approach.

8. *Should one particular area be selected for a pilot project to test the operation of a reverse auction? If so, based upon what considerations?*

DRA strongly recommends that the Commission test the operation of a reverse auction in at least two distinct geographic areas before deploying the approach throughout California. At least one pilot area should be selected from areas that now qualify for CHCF-B support (and will continue to be eligible at the end of the phase-down adopted in D.07-09-020), but are relatively densely populated and are likely to be attractive to multiple providers. It may also be appropriate to select a second, more sparsely populated area in which there is reason to expect multiple credible bidders (*e.g.*, an area in which a municipality now offers, or one such as Eureka that is considering developing a network that can offer, telecommunications services). The Commission may also wish to hold a trial auction in a remote area in which there may be a limited number of bidders, in order to gain experience in how auctions might be adapted to such circumstances.

9. *Should only one COLR be selected for each area, or should reduced subsidies be available to qualifying competitive carriers?*

DRA preliminarily recommends that only one COLR (or subsidy recipient) be selected for each geographic area for a fixed term. This approach should avoid concerns that have arisen at the federal level about the magnitude of subsidies when multiple Eligible Telecommunications Carriers (ETCs) receive funding for a given area. DRA adds as a caveat that a "winner take all" approach should be used for a finite period of time, and should be combined with periodic subsequent re-auctions that are frequent enough to discipline the behavior of the winning provider, but not so frequent that they discourage potential qualified bidders from participating in the initial auction. For example, the Commission might consider holding the first round of auctions to solicit bids for the receipt of COLR support for a five or ten-year period, with a subsequent round of re-auctions to determine the COLR for the next period.

10. Should the size of the service area subject to reverse auction bidding be set by the Commission or determined by the bidding process?

DRA's preliminary recommendation is that the size of the service area should be determined by the bidding process; however, DRA may revise this opinion if subsequent comments and workshops do not reveal a practical and workable method for the market to determine the appropriate area to be served. Allowing each carrier to determine its subsidized service area might allow carriers to combine service areas at a reduced estimated operating cost. However, too much variance among the proposed service areas may unnecessarily complicate the auction contract award process if the resulting bids are not comparable. This is an example of an issue that may be best resolved through workshops.

11. What is a reasonable cost proxy to serve as an initial auction "reserve" or upper bound on bids that would be acceptable as the basis for payment of support levels? What is the most expeditious manner to derive an appropriate benchmark for setting such upper bounds? As a default, should any qualifying upper bid be at or below the existing B-Fund support level for designated areas subject to the auction? If the HM 5.3 Model is used to designate areas subject to the auction, should a cap be placed on the results? What is a reasonable cap?

DRA's preliminary recommendation is to derive an appropriate benchmark for the upper bounds of support levels based on the final, post-phase-down support levels adopted in D.07-09-020, and adjusted as described in Section IV of these Comments. This would provide the most expeditious approach and one that would eliminate the need for any cost proxy model update litigation. If, however, the Commission chooses to rely on results from the HM 5.3 model, it should cap the results of that model to avoid providing more support than necessary. *See* DRA's comments in Section IV below for a detailed discussion of DRA's proposals to cap HM 5.3 results.

12. What sorts of cost proxy determinations or updates may be necessary or desirable as a basis to identify areas subject to bidding under the reverse *auction? Is there a better approach to forecast service needs of the area for the duration of the COLR designation?*

DRA sees no need for a cost proxy model determination or update. *See* DRA's preliminary responses to questions 10 and 11 above.

13. If an existing ILEC COLR does not submit a selected bid during the auction, should there be any additional requirements that the ILEC make its existing facilities in the designated area available to a new COLR?

Yes. Although the existing ILEC COLR should not be required to build new facilities, it should be required to retain its existing facilities in working order and to make them available to a new COLR on reasonable terms. In particular, the Commission should not allow the incumbents to retire their existing copper-based loop facilities in areas in which they were previously designated as COLRs. The Commission is currently considering the issue of ILECs removal of copper. The recently released Proposed Decision (PD) regarding AT&T's application for exemption for PU Code Section 851 (Section 851) states that URF ILECs can now use a tier 2 advice letter process for all Section 851 applications with a few exceptions. One of those exceptions is that they must use Section 851 for any transactions involving retirement of copper loops and subloops.[17] Further, and even more important at this time, given the recent interpretation of the PU Code Section 2883 requirements in the pending Presiding Officer's Decision in C.05-11-011 (filed on October 10, 2007),[18] any attempt by the incumbents to retire existing copper-based facilities could be seen as a violation of their obligation to make emergency 911 services available to residences that desire that

[17] Proposed Decision of Administrative Law Judge Grau on A.06-07-026, issued October 18, 2007, at 12. This issue will be further addressed in the resolution to CALTEL's petition, P.07-07-009, and related proceedings.

[18] Section 2883 requires "[a]ll local telephone corporations, excluding wireless and cellular telephone corporations, to the extent permitted by existing technology or facilities, [to] provide every existing and newly installed residential telephone connection with access to '911' emergency service regardless of whether an account has been established."

service, regardless of whether the consumers in question currently or previously subscribed to the ILEC's basic local service.

DRA preliminarily suggests that the new COLR be given the option of leasing facilities from the previous ILEC COLR at the ILEC's capped retail rate plus the post-phase-down support level identified in D.07-09-020, less the resale discount. Of course, the Commission should permit the ILEC and the new COLR to negotiate a different, mutually agreeable price. Even if the new COLR does not use the current carrier's existing facilities, however, the Commission should vigorously enforce the 911 service requirements embodied in Section 2883 of the PU Code, as proposed in the pending October 10, 2007 Presiding Officer's Decision in C.05-11-011.

IV. COST PROXY MODEL UPDATE IMPLEMENTATION (SECTION 2.2)

1. In order to mitigate the risks that the HM 5.3 Model may produce anomalous results, how, or in what manner, should the total investment calculation produced by the HM 5.3 Model be capped to avoid excessive subsidies?

If the Commission makes any use of HM 5.3 UNE results, this is a critically important issue. HM 5.3 results were not examined at the CBG level in either the AT&T or the Verizon UNE cost dockets. Indeed, very little attention was paid to geographically specific HM 5.3 results, even at wire center levels, in the AT&T and Verizon UNE cost proceedings. That relative lack of significance for results of discrete geographic areas made sense in the context of a UNE proceeding because UNE prices are not based on granular model outputs but are instead, at the lowest level, based on the average of costs across many wire centers.[19] In the UNE cases, what mattered was that inputs and

[19] Indeed, AT&T has complained about using HM 5.3 results in this proceeding at all because its loop rates were set based on "three zones covering all of AT&T's California's territory." AT&T Reply Comments, 10/16/06, at 15-16.

modeling assumptions produce results that were, on average, reasonable over larger areas.[20]

One example of a problematic issue relative to the use of CBG-level results from HM 5.3 is that, when AT&T or Verizon were unable to provide adequate customer location information, the model randomly distributed customers. In the model run for the Verizon UNE case, more than 8% of all customer locations were randomly assigned or surrogated.[21] Over large areas, this averaging in of additional demand may be reasonable. However, in rural (and likely high-cost) areas, where large areas may not actually require any loop plant at all, such random placement of customers can result in exaggerated loop lengths and costs. Other jurisdictions have recognized that this feature of HM "systematically overestimates the cost of universal service."[22] The record in California indicates that HM 5.3 estimated more that *five times more distribution cable* relative to the amount of distribution cable Verizon itself modeled and claimed was necessary based on its actual network routing in its least dense (*i.e.* most rural) service areas.[23] Hence, there is good reason to believe that HM 5.3 may substantially overestimate costs in some low-density rural areas.

Potentially even worse, some of Verizon's customer location data used as inputs to HM 5.3 included locations that "geocoded" to areas far outside of Verizon's actual service boundaries.[24] Parties attempted to correct these anomalous locations in rebuttal.[25] However, the Commission rejected all revisions to HM 5.3 that were filed in rebuttal.[26]

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[20] For example, the assumption that 50% of coin flips will be heads may be a good modeling assumption if one is modeling what happens, on average, over 100 flips. However, if one needs to know what the result was for a particular one of the series of 100 flips, the 50% heads modeling assumption will produce an incorrect result 50% of the time.

[21] R.93-04-003/I.93-04-002, Mercer Direct, November 3, 2003, Attachment RAM-4 at 21.

[22] R.93-04-003/I.93-04-002, Mercer/Pitkin/Turner Rebuttal, November 9, 2004, at 51-52.

[23] R.93-04-003/I.93-04-002, Mercer/Pitkin/Turner Rebuttal, November 9, 2004, at 50.

[24] R.93-04-003/I.93-04-002, Landis Rebuttal, November 9, 2004, at 18.

[25] R.93-04-003/I.93-04-002, Landis Rebuttal, November 9, 2004, at 18.

[26] D.06-03-025 at 43.

Hence, high costs modeled due to such erroneous data would still be included in the model and might significantly distort CBG-level results in some areas.

DRA notes that the ILECs themselves argued that HM 5.3 inflates costs in relatively low-density (high cost) areas.

> The general pattern is that, while HM 5.3 tends to produce greater distances for smaller wire centers (as indicated by low ratios), the ratios tend to be larger as wire center size increases. The cost implication of this outcome is that, relative to VzLoop, HM 5.3 overstates costs in low-density areas, but understates costs in higher density areas. Not surprisingly, it is the high-density areas where Joint Commentors are likely to purchase the majority of their UNEs.[27]

In this proceeding, Verizon's self-interest is reversed, *i.e.*, if HM 5.3 does produce costs that are too high in low-density areas (as Verizon claimed is the case with HM 5.3), Verizon's proposed subsidy calculation would result in greater subsidies for Verizon. Verizon's change of heart relative to the usefulness of HM 5.3 in this context is not surprising. Worse, if the problem that Verizon raised is correct, it will probably lead to substantially inflated results for low-density areas calculated at the CBG level.

Although DRA has not examined HM 5.3 CBG level results, DRA did run HM 5.3 as adopted in the Verizon UNE cost docket (D.06-03-025) and the $36 benchmark from D.07-09-020. Not surprisingly, the HM 5.3 CBG level costs would provide a huge increase in CHCF-B subsidy—about $85 million per year compared with Verizon's draw of about $40 million per year prior to D.07-09-020, even with the $36 benchmark.[28]

Absent some mechanism to reassess HM 5.3 inputs and assumptions at the CBG level, there is a substantial possibility that COLRs would receive windfall payments (i.e., payments that bear no reasonable relationship to either actual incurred or forward-looking costs) based on anomalously high results from HM 5.3 in some areas (and, perhaps, also underpayments in other areas).

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[27] R.93-04-003/I.93-04-002, Reply Testimony of Dr. Timothy J. Tardiff, August 6, 2004, at 35-36 (footnote omitted). Dr. Tardiff was also a witness for AT&T in its UNE case.

[28] *See* Attachment 1.

This issue is also significant because the maximum amount of CHCF-B funding should compensate a provider only for the cost to provide a subsidized service *given the efficient use of available technology*. For example, DRA expects that practically all economists would agree that, if wireless, cable, satellite or some other technology is the least-cost means to provide qualified COLR service in some specific areas, then the cost of that efficient technology should determine the maximum potential COLR subsidy. If the ILEC is not implementing a more efficient option to provide service in areas with more efficient alternatives available, the Commission can presume that is because either (1) the ILEC's actual cost to maintain its legacy embedded facilities (which were funded by ratepayers and subsidies in past decades) *is lower* than the cost of deploying more efficient new technology or (2) that its current subsidy program is, in fact, distorting the market by providing an incentive for the COLR to maintain its, relatively inefficient but subsidized, technology that qualifies for a subsidy at a rate that undercuts deployment of more efficient options.

Unfortunately, no model heretofore reviewed by the Commission includes any assessment of the cost of alternative technology options. Developing a new modeling process for such technologies would be akin to reopening a cost case, which is something DRA hopes that the Commission is (wisely) intent on avoiding.

DRA suggests three potential "work-arounds" for ensuring that subsidy payments are not inflated as the result of anomalous HM 5.3 results. First, the Commission can use a subsidy cap based on a surrogate derived from the prices at which competitors are already offering service using reasonably substitutable services. For example, the Commission could instruct its staff to survey prices for wireless service and satellite service options that are generally available for residential customers in areas that HM 5.3 suggests are already high cost. The lowest generally available wireless or satellite price could then be used to cap subsidy payments, either by region or by CBG. For example, if the Commission found that basic wireless service with a reasonable usage allowance is available in high cost areas in Kern County for $40, it could take that available rate as evidence that an efficient carrier can provide service in those areas for $40 and cap subsidy payments at that level. This approach should limit much of the potential for inflated subsidy payments.

Moreover, DRA notes that it makes sense to include information about wireless, satellite and other service options in setting a cap on subsidy amounts, given the Commission's goal of making the regulatory framework as uniform as possible, as well as its desire to explore modifying the B Fund to include a broader base of providers for B Fund support in this proceeding. For example, if the Commission set a subsidy of $70 per line in some CBGs despite knowing that wireless service providers already serve the entire CBG with a $30 per month plan, the result would be a $40 windfall subsidy per line for the efficient wireless provider should the Commission subsequently modify its COLR requirements so that the wireless service would qualify.

Second, the Commission could rely on its expertise to pick a presumptive limit on the per-line subsidy payments. The Commission previously inquired about the possibility of using an $85 payment cap, which was supported by a number of parties.[29] DRA opposed this option at the time on the basis that some areas might exist in which higher costs genuinely exist.[30] However, based upon analysis of the parties Comments and further review of the issue, DRA now suggests that the Commission could remedy any such potential problem by also providing an opportunity for the existing COLR to provide evidence that its actual operating costs in a specific area are higher than the adopted subsidy cap, whether that cap is $85 or some lower figure.

Third, the Commission also could cap the subsidy for existing lines in high-cost areas at the ILEC's ongoing operations and maintenance cost, as discussed below. As DRA pointed out in its Opening Comments, there is substantial evidence that CHCF-B

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[29] CCTA Opening Comments, 9/1/06, at 9; Cox Opening Comments, 9/1/06, at 12-13; Sprint Opening Comments, 9/1/06, at 2, and; Time-Warner Opening Comments, 9/1/06, at 14.

[30] DRA Reply Comments, 10/16/06, at 39-41.

payments have been much higher than what COLRs actually spend on maintaining residential universal connectivity.[31]

2. Why should any other adjustments be considered?

Adjustments to the adopted HM 5.3 inputs and modeling assumptions should not be considered. Even working with a familiar, adopted version of HM 5.3, it took from a July 2002 ruling until March 2006 to adopt UNE results for a single ILEC (Verizon). Any new adjustment to the inputs or modeling assumptions for multiple ILECs would be hugely contentious. The Commission would first need to litigate what adjustments should be included and which excluded (including what new granularity of inputs might be needed to address the problems described above to make sure that CBG-level results are accurate).

It would then need to provide an opportunity for parties to develop their own proposals for the selected inputs – a process involving not a single carrier but at least four ILECs. Given the resource-intensiveness of any such process, engaging in it is simply not worth the potential value of the results. The adopted input values and assumptions were litigated recently enough for the apparently very limited purpose to which the Commission now intends to use HM 5.3 in the context of universal service funding.

Should the Commission opt to update subsidy payments using HM 5.3, Verizon's proposal to use the adopted HM 5.3 results and existing resale proxies, *with an appropriate cap on CBG-level subsidy amounts (as discussed above)*, is better than other options (although still not a good outcome). DRA notes that AT&T's objections to Verizon's proposal are misguided.[32] AT&T's only significant concern was that the HM 5.3 results are only available at the wire center level. However, CBG-level results can be extracted from the model as it was adopted for AT&T.[33] Given the addition of a cap to

[31] DRA Opening Comments, 9/1/06, at13.
[32] AT&T Reply Comments, 10/16/06, at 15-16.
[33] DRA Further Comments, 4/27/07, at 43.

account for anomalies in the data at that level (as suggested above), AT&T's concern is moot.

It is critical that the CPUC not create an opportunity for the ILECs to cherry-pick updates for inputs that will tend to increase costs while ignoring all of the inputs that would have the opposite effect. For example, if any updates are allowed, the Commission should not entertain ILEC "evidence" that costs have gone up due to labor rate increases without a convincing, detailed showing that other changes such as increased efficiency, new technology, and outsourcing did not "net out" those increases. DRA and other parties would also need to be given substantial time (assuming some parties' limited available resources) to review ILEC data regarding all of the cost inputs that the ILECs themselves do not propose to update to ensure that the update process is not missing significant offsetting cost decreases.

Although DRA has explained why cost studies/models should not be used, if the Commission nonetheless chooses to proceed with the use of a cost study, the approach recommended in Verizon's Opening Comments is the best thing on the table, provided that it is done on a CBG basis and is combined with a cap on payments so that the companies are not receiving a windfall for lines in a relatively few CBGs with anomalous high results.

3. *What other possible adjustments to the cost proxy should be considered in order to avoid excessive subsidies, (e.g., limiting support only to the operations and maintenance costs for existing lines as derived from the model)?*

It is anticompetitive to compensate the incumbents for the fictitious cost of rebuilding old copper, video-incompatible networks indefinitely. No competitor is building such networks today, presumably because they are no longer an efficient option. Moreover, in many, if not most cases, the existing networks were constructed decades ago, and the related investment has probably been fully recovered through a combination of Commission-authorized rates and subsidy payments. Continuing to subsidize ILECs for the full cost of investing in a new, inefficient largely copper network is therefore more likely to hand them an anticompetitive subsidy windfall than to fill any real universal service public purpose.

The Commission should seriously consider limiting any new payment calculation (one that is an intermediate step prior to an auction-based approach or where no qualified competitors participate in an auction) to the COLR's reasonable costs for maintaining existing residential primary lines in designated high-cost areas. In other words, the Commission could limit any subsidy to the best available estimate of the costs a COLR is actually incurring to provide standalone service to customers who select only that service in a high-cost area. Unless an ILEC opts to bring evidence concerning its actual costs to the Commission for examination, the best available estimate would be the adopted HM 5.3 UNE cost results minus the plant investment costs as a proxy.

The Commission might also allow for one-time payments if an ILEC demonstrates substantial undepreciated investment or the need for substantial new investment in a specific area. But, the presumption should be that the ILECs have already recovered their basic service investments. They have been COLRs for decades (prior to the creation of the term "COLR" monopoly providers necessarily provided that same function as part of their monopoly obligation), and their service areas have been relatively fixed. They long ago built out to meet anticipated ultimate demand. Any subsidy to upgrade facilities so that they also support broadband should made with explicit recognition that it is a subsidy to broaden broadband availability and should come with conditions, *e.g.*, that the reward of access to additional broadband revenue comes with the obligation to be an unsubsidized COLR.

4. *What other adjustments to the HM 5.3 model may be appropriate to streamline the updating process while ensuring that the resulting cost proxies are reasonable for deriving B-Fund support levels as an interim transition to the reverse auction?*

This issue is addressed in DRA's responses to other questions in this section.

5. *What procedural measures may be necessary in order to facilitate the timely production of cost model runs, provision for discovery, protection of proprietary data, and other measures to develop an adequate record on cost model updates?*

Ideally, the Commission would limit any use of HM 5.3 to extracting CBG-level results from the adopted versions of the model for AT&T and Verizon and selecting proxy results for Frontier and SureWest.[34] This would likely substantially reduce the need for extensive or time consuming discovery. AT&T and Verizon should arrange for independent HM 5.3 developers to work directly with Commission staff to generate CBG results and add nonloop costs as proposed by Verizon. DRA does not believe that modeled costs at the CBG level are legitimately considered proprietary at all.

It is our understanding that it is really the ILEC-specific customer location, labor and equipment cost data that are ILEC-specific proprietary inputs underlying the adopted UNE costs. Those underlying proprietary inputs would not be discernable from modeled CBG-level results. Indeed, the ILECs have in the past argued that TELRIC-modeled costs are too different from their "real" costs to be used at all. Hence, it is hard to imagine how they can consider such costs as vital proprietary information. This is doubly true given that HM 5.3 models a network with copper distribution that would not be compatible with broadcast television/video service and is thus not what the ILECs would build today in any case. Nonetheless, the Commission could provide an opportunity for the ILECs to make the case that CBG-level results should be protected for some reason.

Should the Commission allow actual model input changes, it would need to allow for sufficient time for parties to obtain ILEC internal data concerning actual current costs for all model inputs and assumptions (as described above). There is no reason to expect that the existing confidentiality agreements would need to be modified.

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[34] The Commission could allow Frontier and SureWest to propose proxy CBGs based on objective correlations in total size, population, density and terrain between CBGs in their service territories and others already modeled in the AT&T and Verizon territories.

V. OTHER PHASE II ISSUES

A. Transitional Rate Caps (Section 3.1)

1. The Commission Should Adopt an Interim, Two-Part Cap While It Develops Data for a "Maximum" Rate Cap

Section 3.1(a) To promote an orderly transition and prevent sudden large rate increases, what maximum level above the currently authorized caps should be set as the revised cap on basic rates for each respective ILEC before full pricing flexibility is to take effect?

DRA Proposal

DRA proposes an interim, two-part cap applicable to all four URF ILECs. First, the Commission should apply explicitly the absolute rate cap on primary-line basic residential service that it implicitly adopted in the URF Phase 1 decision – namely, a cap equal to the highest URF ILEC residential basic service rate in California, SureWest's $18.90 rate level for 1FR service.[35] Second, the Commission should set a relative rate cap for each service provider such that no service provider is allowed to charge rates in any pricing zone of its service territory that exceed 150% of the lowest rate that service provider charges in any other pricing zone for the same service.[36] This interim, two-part cap should be applied while the Commission gathers the reliable, California-specific data that is needed to determine an appropriate "maximum" rate cap according to a total telephone bill amount that is truly affordable.

Rationale for DRA's Proposal

In addition to meeting the objectives of promoting an orderly transition and preventing sudden large rate increases identified in Question 3.1(a), basic rate caps also should be consistent with the legislative purpose of the CHCF-B program, which is "to

[35] The SureWest rate was set as an implicit cap in the URF Phase 1 decision. D.06-08-030 at 156-157.

[36] *See* DRA's response to Section 3.2 of the 10/5/07 ACR for how this relative rate cap should be applied to non-ILEC COLRs,

promote the goals of universal telephone service and to reduce any disparity in the rates charged by those companies."[37] The Commission has used a target of at least 95% penetration rate of basic telephone service as fulfilling the goal of universal telephone service; thus, the Commission should ensure that basic rates do not go so high as to jeopardize a 95% penetration rate – and should seek to meet this standard *for all geographic areas and demographic groups*.

DRA's proposal for an interim basic rate cap of $18.90 is designed to preserve California's current high standard of universal service. Based on the data that are currently available, $18.90 is as high as (or higher than) the Commission can allow basic service rates to climb with any reasonable expectation that it will not jeopardize universal service goals. Indeed, DRA notes that the ultimate price cap needed to maintain California's high standard of universal service may be *below* SureWest's current $18.90 rate.

When one considers all additional fees and federal and state charges, it appears that a SureWest customer with flat-rate basic service and no other charges would actually pay about $28.78. AT&T's equivalent rate is about $17.50.[38] Thus, a cap at SureWest's rate level would boost AT&T's California customer rates by 64% and California-wide rates from (presumably) somewhere significantly below nationwide average levels of $24.74 for basic service and the median of $23.95 to well above those levels.[39] Because SureWest's rates are so high, the Commission cannot presume that they are not already

[37] PU Code § 739.3 (c).

[38] While the absolute amount on the bill will vary from month to month, this is due to the fact that public purpose program surcharges are applied to the bill itself (with some very limited exceptions). Consequently, because the amount of the bill against which the surcharges are incremented is variable, the total amount will vary from month to month.

[39] *Reference Book of Rates, Price Indices and Household Expenditures for Telephone Service*, Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, 2006, Table 1.1.

harming universal service goals without first conducting a serious examination of, and obtaining real data about, service affordability requirements.[40]

Such substantial increases in basic rates outside the SureWest service territory are likely to reduce penetration rates in California, but the Commission currently has no basis for determining whether that would happen or how large the effect would be. The Commission does not even know whether the 95% universal service target is being achieved at today's rate levels throughout the four major ILECs' service territories. It is entirely possible, for example, that SureWest's $18.90 basic service rate already has reduced penetration rates in its service territory relative to other areas in California.

Therefore, DRA recommends that the interim basic rate cap remain in place until such time as the Commission has gathered enough data to allow an accurate evaluation of how high basic rates in California can go in various parts of the state before they cause penetration rates to drop below the Commission's 95% target penetration rate. Nationwide data are not sufficient for this purpose. For example, California's relatively high cost of housing and other basic needs leaves less discretionary income for California consumers to spend on telecommunications service, so that penetration rates could fall below 95% even at basic service rates that are below the national average.

Moreover, affordability could vary substantially by county (and perhaps even more on a more granular level). For example, if penetration rates were to drop below 95% when basic service rates exceed 0.5% of median household income, then the "affordable" basic rate (that is, the rate consistent with the Commission's universal service goals) would be about $12.36 in Modoc County, but would be as high as $28.68 in Santa Clara County.[41]

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[40] *See* DRA Further Comments, 4/27/07, at 8 and 52; and R.05-04-005 (URF), Further Proposal of the Division of Ratepayer Advocates for New and Reinstated Monitoring Reports, 2/7/07, at 27, 29 and Appendix D.

[41] Based on median household income by county using modeled 2004 dollars from http://www.census.gov/cgi-bin/saipe/saipe.cgi?year=2004&type=county&table=county&submit=States%20%26%20Counties&areas=all&display_data=Display%20Data&state=06#SA91

For these reasons, the Commission should not lift the interim rate cap or set a new, permanent cap until it obtains geographically and demographically disaggregated baseline information about penetration rates in California and customer perceptions of affordable basic service rates (both for low-income and average-income customers). The Commission also should obtain data about customer response (again, on a geographically and demographically disaggregated basis) to the initial rate increases permitted under the phase-in approach to price increases that DRA proposes herein.[42] If increased basic service rates reduce penetration rates below 95%, the Commission could reduce the rate cap or mandate other programs to boost connectivity. Furthermore, and for the same reasons, the "final" ILEC rate cap developed by the Commission should be used to determine the COLR rate cap, the maximum "basic telephone rate" that a COLR can charge in a subsidized area and continue to receive B fund money, as discussed in Section B below.

Notably, the CHCF-B has heretofore done nothing at all to achieve the legislative mandate to reduce the disparity in rates between and among the various subsidized companies.[43] DRA's proposals would accomplish this goal by maintaining a cap at SureWest's current rate and gradually allowing other carriers to increase rates, at a maximum, to that level (at least on an interim basis). Given the Commission's decision to permit geographic deaveraging, however, it will take more than absolute rate caps to avoid unacceptable levels of rate disparities between urban and rural customers. DRA's proposal, as discussed below, to limit the highest rate for any one company to 150% of its lowest rate for the same service addresses this concern.

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[42] The Commission could rely on the Field Research affordability study previously recommended by DRA to accomplish this goal. DRA Further Comments, 4/27/07, at 8 and 52. By the time the basic rate increases begin, the Commission's revised Lifeline program also should be in place, permitting an empirical determination of the effect of retail rate increases on penetration rates, given the entire revised regulatory framework.

[43] DRA Opening Comments, 9/1/06 at 8-9.

Maintaining a cap that does not allow rural rates to soar unreasonably high relative to urban rates is particularly important given the Commission's recent finding that it "cannot confirm that ubiquitous cost-based pricing for basic service would remain affordable" absent a subsidy for the ILECs because, although competition theoretically exists that is capable of serving rural areas, competitors are not necessarily willing to actually serve those areas at affordable rates.[44]

2. The Rate Cap Increases Should Not Exceed $2.00 Per Year

Section 3.1(b) What period of time is appropriate for the phase-in of increases in the caps on ILEC basic rates to transition from current levels to a level at which further cap restrictions can be eliminated and full pricing flexibility implemented?

As discussed in DRA's response to Section 3.1(a) of the 10/5/07 ACR, above, the Commission has the obligation to obtain additional reliable data that is California-specific in order to identify an "affordability standard" for the purposes of basic residential telephone services. Furthermore, it is vital that the Commission distinguish between a rate for basic residential service, which is the amount at which ILECs are currently capped, and the total bill for basic residential telephone services, an amount that includes local rates and surcharges and which should be used to determine whether a phone bill is truly "affordable." DRA has proposed in Section 3.1(a) the most reasonable parameters for a short-term, interim rate cap given the lack of reliable data, as well as a longer-term process for determining what an affordable basic phone bill is in California using, among other data, a modified Affordability Study conducted by Field Research.

Without knowing the total phone bill amount that is affordable for California customers, however, it is not possible to identify at this time a specific phase-in period that will prevent rate shock before full pricing flexibility is allowed. Instead, based on DRA's recommendation to use, in part, SureWest's basic residential rate as an interim

[44] D.07-09-020 at 34.

"affordable basic rate," DRA proposes a phase-in period that would allow an absolute maximum rate increase of $2.00 per year. For Verizon and Frontier, whose basic residential rates are currently capped at either $16.85 or $17.25, and $17.85, respectively, this $2.00 maximum annual rate increase would effectively require a "phase-in" period of only one year.

For AT&T, which has by far the lowest residential basic exchange rates in California, a $2.00 increase is nearly 19% relative to AT&T's current base rate. Because of the taxes and other charges that apply to basic service, a $2.00 basic rate increase would produce an even larger monthly increase for AT&T's California customers. DRA remains concerned that this amount is an inordinately large single-year increase for some customers. Given AT&T's many claims regarding the supposed intensity of competition, however, DRA presumes that AT&T will not implement anything close to such a significant rate increase. Indeed, in recent URF hearings about competition, AT&T's economic witness repeatedly assured the Commission that AT&T would be "stupid" to increase basic service rates if granted the flexibility to do so.[45]

Allowing an annual basic rate increase of no more than $2.00 per line is an essential minimum curb on potential rate shock. Significantly, even if the Commission had considered rate-rebalancing for AT&T, which D.07-09-020 properly rejected, there would be no need for any increase in AT&T's basic rate above $2.00 in any event. AT&T's entire monthly draw from the CHCF-B (as an ILEC) was $29,008,709 prior to D.07-09-020.[46] Its total residential access lines as of year-end 2006 were 8,461,635.[47] Thus, an increase of $3.43 per month per residential line would totally offset AT&T's pre D.07-09-020 draw from the CHCF-B. However, the Commission has already determined that AT&T's subsidy should be reduced to $17,540,801 on January 1, 2008, which would

[45] R.05-04-005, Dr. Harris on 1/30/06 at R.T. 364 and 1/31/06 at R.T. 382-384.

[46] D.07-09-020, Appendix Table 1.

[47] Sum of AT&T residential lines from the FCC ARMIS 43-08 report.

be offset by a total increase per line of $2.08, and to $6,439,067 on July 1, 2009, which would be offset by a total increase per line of $0.76.[48]

Additionally, AT&T's recent monthly rate increases for popular residential options such as WirePro ($2.01), non-published listings ($0.86 or $0.97, depending on option selected), and custom calling features ($2.83 for caller ID, $1.77 for other features) could easily amount to a weighted-average increase of *far more* than AT&T's reduction in subsidy, even without any increase in the basic service rates. Thus, AT&T appears to have "pre-funded" the potential elimination of its entire CHCF-B draw. In any case, a $2.00 per-line annual increase is more than sufficient to make up for any remaining shortfall.

B. Certification Process to Qualify for B-Fund Support (Section 3.2)

DRA supports the Commission's adoption of a COLR cap to ensure that carriers receiving B funds cannot indiscriminately increase basic residential service rates. DRA recommends two measures of affordability to which COLRs should adhere, consistent with DRA's proposal for a two-part approach for ILEC rate caps. First, the "affordability" level that the Commission will develop, using data garnered from sources like Field Research's Affordability Study, should be treated as the "COLR basic service telephone rate cap," which a COLR must annually certify it meets in order to continue receiving funds.

Second, as explained above, there should be a disparity of no more than 150% between the lowest and the highest basic residential rate that the COLR charges anywhere in its California service territory. To the extent that a winning bidder in a reverse auction has no service territory in California other than the bid area, this mechanism could be applied using a specific dollar amount identified by the Commission as a "proxy" for the "lowest rate." Using the ILEC that is geographically closest to the

[48] D.07-09-020, Appendix Table 1.

service territory of the COLR, the proxy could be related to the lowest rate that that ILEC has or had at a certain point in time.

This second measure of affordability provides a method to ensure that rates in high cost (likely rural) areas are reasonably comparable to the rates offered in urban areas, given full pricing flexibility and the current lack of a definitive, data-based definition of "affordability" at this time. This 100/150% rate comparison has already been adopted by the Commission in prior decisions for the purpose of determining the maximum rate that small incumbent local exchange carriers (Small LECs) can charge, relative to AT&T's rate. The Commission has thus already found such a range of rates to be just and reasonable in the context of comparing high cost and non-high cost areas.

As a Commission-approved, viable way to establish a reasonably comparable mean between low density (and therefore, presumptively high-cost) and high density (relatively low-cost) areas of California, the 100/150% rate disparity mechanism can easily be extended to B-Fund areas. Using this rate mechanism, in coordination with the interim definition of affordability discussed in Section 3.1(a), above, will help ensure just and reasonable rates, consistent with the Commission's statutory mandate.

C. Broadening the Base for Eligibility to Receive B-Fund Support (Section 3.3)

The 10/5/07 ACR seeks comment on whether wireless and other intermodal carriers should be eligible to participate in the B Fund. Expanding the base of possible B Fund recipients has the potential to benefit residential consumers while furthering the Commission's goal of adopting policies that are competitively neutral. DRA supports a further exploration of how to accomplish such an expansion while maintaining "a certain minimum level of telecommunications services" at an affordable rate throughout California.[49] As the Commission recognized in D.07-09-020, such an exploration raises

[49] D.07-09-020, *mimeo*, at 15 (citing D.96-10-066, *mimeo*, at 16).

the question of whether, and how, to change the definition of the service elements that COLRs must provide.[50]

Some COLR requirements now appear to be so inherent to voice services, including touch-tone dialing, the ability to place and receive calls, and access to single party local exchange services, that it may be unnecessary to even identify them as basic service elements. Other elements of basic service have underlying goals that may now be effectuated with different services and/or technologies. For example, a COLR is required to provide free toll-blocking to Lifeline customers, which allows the customer greater control over the charges that he or she incurs.[51] A wireless carrier, however, could theoretically accomplish the same goal by suspending in and outbound phone service (except for emergency calls) after the minutes in a Lifeline customer's plan have been used up.

Further, the perceived benefits of some basic service elements have shifted dramatically. For example, residential customers may no longer value the ability to list one's number in a white pages directory (a directory assistance listing). Wireless customers have opted for service that does not offer that option, and many wireline customers actually pay to ensure their numbers do not appear in any directory assistance listing. The Commission should consider how the changing values of ratepayers should affect the definition of basic phone service.

There may be other ways in which the requirements that currently make up "basic exchange service" and "Lifeline service" could be modified to enable intermodal carriers to participate in the B Fund program. The carriers themselves, however, are the most knowledgeable about what elements of "basic service" are effectively limiting participation in the B Fund program. It is the carriers that know whether a specific requirement is feasible for them or not, and whether there are alternatives that could

[50] Currently, COLRs must provide the services identified in D.96-10-066, Appendix B, including Lifeline services that are separately identified in General Order 153, Appendix A.

[51] General Order 153, Appendix A.

fulfill the underlying goals of a specific requirement. DRA therefore urges the Commission to solicit from potential intermodal participants the specific elements of basic exchange service that act as a disincentive to participating in the program. In soliciting this information, however, it is critical that carriers identify how and why a service element acts as a disincentive, as well as to provide options for how that disincentive can be remedied.

In order for the Commission to fully understand whether a current requirement is technically or economically infeasible, and to explore alternatives to current requirements, DRA recommends that the Commission invite potential intermodal B Fund participants to present their views and engage in a dialogue in a workshop. In such an invitation, the Commission should invite intermodal carriers that may not currently be on the service list for this proceeding, including wireless and fixed VOIP carriers.

D. Standards/Procedures for Future Periodic Review of the B-Fund Program (Section 3.4)

As DRA has explained, the Commission should conduct a pilot program in order to get experience with running reverse auctions and make any necessary adjustments to its preliminary auction rules and protocols prior to implementing reverse auctions throughout the state. The Commission should establish a time frame for review of the revised B-Fund program. The clock should start running after the reverse auction pilot program is completed and any necessary adjustments are made and statewide implementation of reverse auctions begins.

DRA is not able, at this time, to recommend a particular time frame for reviewing the program. Determining a reasonable time for review of the program's effectiveness requires that some parameters be established for conducting the review. To that end, DRA recommends that the topic of review parameters and length be included in the workshops discussed elsewhere in these Comments so that potential bidders can provide their input. For example, DRA envisions the COLR bids will be for some fixed period of time rather than in perpetuity.[52] The length of the COLR obligation may need to be different if a bidder needs to construct facilities than if facilities are already deployed, in order to make the bid economically viable. That raises the question of whether the Commission should conduct reviews during the life of the bid, or wait to review the program until the selected bid's term has ended.

Program review is also necessary in the event that no service provider bids for a particular area that is being auctioned. In that situation, DRA recommends that the ILEC then retains the COLR obligation, as it is the existing COLR. This would create a situation where B Fund draws are essentially bifurcated: some service providers would be drawing the fixed amount of subsidy per line which they bid and won (which would, of course, vary among the various winning bidders), and some ILECs would be drawing based upon the B Fund as it is currently constructed. This difference in draw method would necessarily result in two different sets of program review parameters.

DRA further recommends that in the "no bidder" situation, the ILEC should not continue its B Fund draw in perpetuity. The Commission should set a time limit on how long the ILEC can continue its B Fund draw. If the ILEC wishes to continue receiving B Fund money, it should be required to make a showing that the area is truly "high cost," *e.g.*, the cost to serve exceeds the benchmark.

E. Streamlined Administration of B-Fund Receipts and Disbursements

DRA believes it is premature to address this topic, and will respond to any suggestions made by other parties. This issue would be more appropriately addressed after necessary workshops are held and parameters are developed for the reverse auction process.

[52] *See* DRA response to Section 2.1.3 of the 10/5/07 ACR Section above.

VI. CONCLUSION

For all of the reasons discussed above, DRA recommends that the Commission focus on reverse auction and affordability issues, deferring further consideration of any proxy cost model update until it has developed a preliminary auction design and identified a sufficient number of potential bidders to make an auction worthwhile. DRA also urges the Commission to adopt interim rate caps for the URF ILECs that allow no more than a $2.00 annual increase in basic residential rates up to the level of the absolute basic residential rate cap. Finally, DRA recommends that the Commission solicit additional input in the form of workshops from potential B Fund recipients to both design an auction process and reconsider the definition of basic service.

Respectfully submitted,

/s/ NATALIE D. WALES

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November 9, 2007

ATTACHMENT 1
ESTIMATE OF VERIZON-CA CHCF-B SUPPORT
USING ADOPTED HAI 5.3 UNE COSTS ON A CBG BASIS
WITH A $36 BENCHMARK

CBG Monthly Cost	No. of CBGs	No. of Lines	No. of Households	Total Annual Support
$0-5	-	-	-	-
$5.01-10	16	18,029	435	-
$10.01-15	237	838,588	186,585	-
$15.01-20	706	2,528,492	1,145,026	-
$20.01-25	194	613,282	322,548	-
$25.01-30	70	151,957	85,526	-
$30.01-40	74	99,546	58,702	$274,800
$40.01-50	43	46,763	27,510	$2,845,567
$50.01-75	90	61,154	37,040	$11,067,357
$75.01-100	54	29,065	17,871	$10,811,291
$100.01-150	70	26,189	17,734	$17,999,515
>$150	174	33,431	19,755	$42,329,941
Total	**1,728**	**4,446,496**	**1,918,732**	**$85,328,471**

Number of supported lines = 178,612
Average monthly support per line = $39.81 (with no cost cap)
Current Verizon annual draw (with $20.30 benchmark) = $49,021,596 (PD, Appendix Table 1: Verizon monthly draw *12)

Compare to DRA 10/16/06 Reply Comments at 32: "Applying Verizon's methodology as exactly as possible, DRA estimates that Verizon would receive over $60 million in CHCF-B funding annually, with support flowing to 114 Verizon wire centers with over 153,209 supported lines." The figure in DRA's Reply Comments was calculated at the $34.21 federal safe harbor rate. Thus, use of CBGs ***increases*** the number of supported lines and ***increases*** the amount of support relative to the wire-center calculation. We can reasonably expect that the CBG version of AT&T's support would be equal to or greater than that calculated by DRA for the wire-center level. "On the same basis, DRA estimates that AT&T would receive nearly $77 million in CHCF-B funding annually, with support flowing to 208 AT&T wire centers with 348,012 supported lines." *Ibid.* (*Note also* that the CBG results here may be somewhat understated because they do not include as much retail cost as did Verizon's proposed method.)

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of OPENING COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON PHASE II ISSUES in R.06-06-028 by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on November 9, 2007 at San Francisco, California.

/s/ CHARLENE D. LUNDY

Charlene D. Lundy

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